Port of Seattle

Internal Audit Report

Bell Harbor International Conference Center
Management Services Agreement No.488

Audit Period

January 1, 2005 through December 31, 2007

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Table of Content

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Internal Auditor's Report

We have completed an audit of the Bell Harbor International Conference Center (BHICC). The Port of Seattle owns the BHICC, and management of the BHICC is outsourced to Columbia Hospitality, Inc. (CHI), a private company that oversees the day-to-day operations of the Facility. The Port Real Estate Property Management Department administers the management services agreement.

We conducted the audit using due professional care. The audit was planned and performed to obtain reasonable assurance of Columbia Hospitality Inc.'s compliance with the management services agreement. We also evaluated the effectiveness of Port management's monitoring system.

Port management has the primary responsibility to establish and implement internal controls. Our role was to assess and evaluate the controls in order to determine whether the controls were adequate and operating effectively.

We have identified opportunities to improve the effectiveness of Port management's monitoring practices, which are discussed in the subsequent sections of this report.

We extend our appreciation to Port Real Estate Property Management and Columbia Hospitality, Inc. staff for their assistance and cooperation during the audit.

Sincerely,

Kirangi

Joyce Kirangi, CPA
Internal Audit Manager

Port of Seattle

Internal Audit Report
Bell Harbor International Conference Center (BHICC)
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Executive Summary

Audit Scope and Objective The purpose of the audit was to determine whether:

1) Columbia Hospitality, Inc. complied with the provisions of the management services agreement, as well as other applicable laws and regulations.

2) Port management effectively monitored the agreement with Columbia Hospitality, Inc.

Agreement Terms The BHICC management services agreement with CHI provides a 3% Base Management Fee, based on gross revenue, and an Incentive Management Fee ranging between 17% and 32%, based on net profit.

CHI is responsible for overall management of the BHICC, including sales & marketing, and food & beverage consumed at the Facility.

Audit Result Summary Columbia Hospitality Inc. materially complied with the terms of the agreement. We determined Port Management was ineffective in monitoring the agreement with CHI; the audit disclosed a number of comments or exceptions. This report identifies opportunities for Port management to improve the effectiveness of its monitoring system.

Background

The Port of Seattle owns the Bell Harbor International Conference Center (BHICC) training Facility which also provides a meeting place for local and international businesses. The BHICC mission is to maintain the highest quality international conference center, which supports the Port mission of fostering international trade and commerce.

The BHICC derives most of its revenues from providing a full range of conference services to include audio visual, food, beverage, meeting room rental, and catering for private and social events.

At a fee, the Port has outsourced the management of the BHICC to Columbia Hospitality, Inc. (CHI), a private company that runs the day-to-day operations of the BHICC on behalf of the Port. All revenue generated by the Facility is remitted to the Port, and the Port pays for all the Facility operating expenses, including costs related to compensation, benefits, and payroll taxes for CHI employees working at the BHICC Facility.

Financial Highlights

Table 1 - Revenue

Description	2005	2006	2007
Conference Service Package	$1,708,425	$1,725,773	$1,712,896
Audio Visual	898,645	1,064,737	1,147,094
Food	3,408,598	4,002,095	4,100,142
Beverage	512,872	741,469	718,280
Meeting Room Rental	441,413	476,276	688,630
Other Miscellaneous	553,078	728,887	748,751
Total	**$7,523,031**	**$8,739,237**	**$9,115,793**

Source: Bell Harbor International Conference Center Revenue Accounts

Table 2 - Expense

Description	2005	2006	2007
Audio Visual	$371,259	$389,922	$457,186
Food	2,224,012	2,701,701	2,763,788
Beverage	91,514	132,448	139,044
Conference Services	748,946	824.518	971,324
Others	2,653,559	2,913,212	2,785,308
Management and IMF fees	550,573	694,912	758,099
Total	**$6,639,863**	**$7,656,713**	**$7,874,749**

Source: Bell Harbor International Conference Center Expense Accounts

Audit Objectives

The purpose of our audit was to determine whether:

1) Columbia Hospitality, Inc. complied with the provisions of the management services agreement, as well as other applicable laws and regulations.

2) Port management effectively monitored the agreement with Columbia Hospitality Inc.

Audit Scope

The scope of the audit covered the period 2005 through 2007.

Audit Approach

We performed the following audit procedures:

- Obtained an understanding of Bell Harbor International Conference Center (BHICC) and Real Estate Management operations related to the BHICC.
- Reviewed applicable state and local laws, rules and regulations, and Port policies.
- Analyzed the data (internal and external) to achieve audit objectives.

Conclusion

An effective and efficient monitoring system should be based on an analysis of risks, and an identification of the key controls that may mitigate those risks. Management then determines which controls to monitor. Our audit focused on the effectiveness of Port management's monitoring system.

Columbia Hospitality Inc. materially complied with the terms of the agreement; however, we determined that the current Port monitoring system is not effective in managing the risks associated with the BHICC management services agreement. Our report has identified opportunities to improve the effectiveness of the management monitoring system.

Summary of Findings and Recommendations

I. Port Management was Ineffective in Monitoring the BHICC Management Agreement

A well-designed and well-placed system of monitoring is necessary to provide management with reasonable assurance of compliance with agree-upon terms and conditions. Such a system should be based on an analysis of risks related to the agreement and an identification of key controls that may mitigate identified risks. Management then determines what controls to monitor and how the controls will be monitored.

During the period under audit, Port management monitoring of the management services agreement was not effective. The audit disclosed a number of discrepancies to include questionable expenses. An effective ongoing monitoring system should have identified and remedied the discrepancies. Internal Audit does acknowledge the presence and performance of certain “continuous active” monitoring controls by management. It is the overall design and effectiveness of those controls that Internal Audit questions.

a. Lack of an Established Level of Monitoring Related to the Third-party Employee Compensation Costs Paid by the Port

The Port pays 100 percent of the BHICC operating expenses including costs related to compensation, bonuses, benefits, and payroll taxes for CHI employees working at the BHICC Facility.

CHI, the private company that manages BHICC has a bonus program, and bonuses are a major part of CHI non-hourly employee compensation. Port management paid bonuses for CHI employees in the amount of $387,791, $473,769, and $511,791 for 2005, 2006, and 2007, respectively. The majority of the bonuses were paid to CHI senior management.

Although the day-to-day running of BHICC is managed by a third-party, Port management is accountable and has the primary responsibility to ensure that costs paid are reasonable and appropriate for a public agency such as the Port. Bonuses are a legitimate expense under the management agreement; however, there is no evidence that Port management ever reviewed, questioned, or approved *the reasonableness* of the bonuses paid.

Port management does review the annual budget and financial plans submitted by CHI, but these plans only show projected revenues and expenses at a high summarized level and details such as bonuses are not transparent. Also, the monthly monitoring of expenses conducted by the property management group does not seem to address the meaningful risks.

Below is a table illustrating 2006 compensation data for some of CHI's senior positions.

Position Description	Wages	Bonus	Total Gross	% of Bonus to Gross
1	$84,075	$35,617	$119,691	30%
2	148,734	67,788	216,522	31%
3	83,641	32,950	116,591	28%
4	94,913	42,859	137,772	31%

Recommendation

- Port management should establish a foundation for monitoring its third-party management agreement based on perceived risks.
- Port management should implement an appropriate level of monitoring and review to ensure that BHICC costs related to third-party employee compensation are reasonable and acceptable.

Management Response

The Management Agreement grants CHI the discretion to hire, manage and terminate staff. As described, all personnel hired by CHI for the BHICC facility are CHI's employees and not the Port's. Bonuses are included as part of employee compensation. While Bonuses are not broken out as a separate line item, the Annual Plan (Budget) submitted by CHI and approved by the Port includes the total compensation for all employees assisting in the operation of the BHICC facility.

b. Unsubstantiated Methodology or Support for Cost Allocation

CHI manages 2 properties for the Port of Seattle—Bell Harbor International Conference Center (BHICC) and the World Trace Center Seattle (WTCSE). It also manages 12 other private properties not associated with the Port.

We found no evidence to support how some CHI general employee costs were allocated among the various properties. Without such a plan, or concurrence from Port management, we could not ascertain the reasonableness of the following CHI employee compensation costs charged to the BHICC and paid by the Port:

- 100 percent of CHI compensation costs for the General Manager, Controller, and Asst. Controller, and some costs for the Chief Operation Officer—approximately $909,275 charged in 2006 and in 2007.

- 50 percent of CHI Corporate Accountant compensation costs--approximately $14,030 in 2005, and $17,550 in 2007.

- 100 percent of compensation costs for 3 full-time and 1 half-time CHI Human Resources staff--$310,057 for 2006 and 2007. CHI has 7 Human Resources staff.

- 100 percent of compensation costs for 12 full-time CHI sales, marketing, and events planning personnel--$1,134,918 in 2006 and in 2007 combined. CHI has 23 sales, marketing, and event planners.

- We also questioned the reasonableness of some other general expenses allocated to BHICC and paid by the Port. Other charges lacked adequate support to show their appropriateness to a public agency such as the Port.

Given the number of non-Port properties managed by CHI during the review period, we can not ascertain that the above-referenced positions expended all or the majority of their time managing Port property--BHICC. For some other general expenses charged to BHICC, we could not substantiate the basis or reasonableness of the allocation costs. The Port might have overpaid its share of the costs.

Recommendation

- Port management should obtain, review, and approve the cost allocation plan that shows how its third-party contractor allocates costs among the properties under its management.

Management Response

As explained by CHI and concurred with by Port staff, CHI has certain employees that are 100% assigned to the BHICC and WTCSE facilities and thus their compensation and benefits are appropriately 100% allocated those facilities. These employees include the General Manager of BHICC/WTCSE, the Assistant Controller as well as the described Sales, Marketing and Event Planning and Human Resources staff. In general, the allocation percentages attributed to CHI employees who are partially assigned to BHICC is established in the Annual Plan (Budget).

Port staff agrees that the allocation percentages for key staff should be reviewed and agreed upon in connection with the approval of the Annual Plan. Any significant *changes to these allocation percentages during the year should be reported in the monthly reporting package.*

c. Improper Advance of Public Funds for Private Activities

As part of the management services agreement, Port management has advanced some working capital (funds) to CHI for payment of the day-to-day expenses of BHICC. We noted the following instances where CHI used the Port working capital funds to pay for expenses belonging to Cruise Terminal of America (CTA) and other private properties.

- $8,263 in February 2004 for utility; the amount not reimbursed by CTA until February 2005; a year later. CTA is an affiliate of CHI and is not covered by the management services agreement.
- Other minor expenses paid for CTA, and reimbursement made to BHICC within a month or two.
- CHI maintains a receivable account in the BHICC books to track private expenses paid with Port working funds. For a 3-year period ending 2007, BHICC incurred approximately $68,000 of private expenses. The majority of these expenses were for lease payments for CHI copy machines, and the rest of the costs related to other expenses for 5 private properties under CHI management.

While BHICC (Port) was fully reimbursed at a later date for the expenses noted above, public funds were comingled with activities of other private companies. These private companies are affiliated with CHI, but are not covered by the Port management services agreement. The above exceptions clearly indicate the use of public funds for purposes not agreed to in the management agreement. Further, the Port incurred a loss of cash flow (i.e., interest) associated with the advance for a period until reimbursement.

Recommendation

- Port management should closely monitor activities of the third party management agreement to ensure that Port working funds are not used for activities not related to the Port.
- Port management should evaluate and analyze the mount of working funds advanced to its third-party contractor and determine whether the funds are excessive in light of the improper advancement of public funds.

Management Response

By the end of 2006, to tighten controls, BHICC stopped paying any expenses on behalf of CTA. In all cases these expenses were reimbursed by CTA.

The receivable account described in the report is effectively an intercompany receivable/payable account. The most significant item run through the account is payment for a copy machine that is shared by CHI run facilities at Pier 66 to take advantage of a quantity discount. The copy machine contract is about to expire. With the expiration, CHI will enter into a separate contract for BHICC and will no longer share use between facilities. In the interim, CHI will begin to pay the copier lease payment and then bill BHICC for its share of use. In addition, going forward, CHI Accounting personnel for BHICC and World Trade Center Club have been advised to pay only invoices directly related to those facilities out of the Revolving Operating Accounts.

The amounts established in the revolving fund for Bell Harbor International Conference Center are based on the highest two months of operating expenses as approved in the annual budget and plus an additional $300,000. This additional amount enables the business to accommodate unanticipated high levels of activity such as occurred in 2007 and 2008.

d. Improper Classification of Expenses

The management services agreement under Section M 3 states, "*CHI must consult with the Port promptly if total Operating Expenses for any three month period exceed the Annual Plan by more than 10 percent…"*

We observed that CHI netted BHICC revenues with expenses in the amounts of approximately $276,287, $438,279, and $318,351 in, 2005, 2006, and 2007 respectively.

Had the netted amounts been properly classified as expenses, the 4th quarter of 2006 and the 3rd quarter of 2007 would have exceeded the 10 percent threshold that requires CHI to consult with the Port. Because the current Port management monitoring system does not include an analysis of the BHICC financial activity, this reporting discrepancy went unnoticed for a number of years.

Recommendation

- Port management should closely monitor activities of its third-party management services agreement to ensure that the reporting terms of the agreement are complied with.
- Port management should strengthen the current monitoring procedures to include periodic analysis of the BHICC financial activities.

Management Response

The particular expenses that Internal Audit is referring to were the result of "pass through transactions". Pass through transactions are situations where a BHICC customer requests a specific item(s) such as furniture, audio-visual equipment or special linens *that have to be rented from an outside vendor by BHICC. The revenue that these expenses were offset against was the amount BHICC charged the customer for the use of the rented item. In other words, BHICC was passing through the cost of the rental to the customer and was recording the revenue net of the direct cost of the rental.*

Effective in 2008, revenue from pass-through transactions for BHICC is recorded on a gross basis and the related expenses are recorded as an operating expense.

e. Ineffective Monitoring of Sales Activity to CHI and its Affiliates

Section R of the management services agreement – discounts for use of Facility, states:

"CHI shall not grant discounts for use of the Facility on the basis of any contractual or business affiliations the user may have with CHI or any entity connected to CHI. Provided, however, CHI may grant discounts to organizations with which it has contractual relationships so long as any discount shall not exceed that offered to any independent user or patron of the Facility under similar booking conditions."

BHICC generally grants approximately 10 percent discount to its preferred customers. We tested 35 invoices billed to CHI and its affiliate companies in order to verify sale completeness and discounts given to this group.

The detail of each invoice was compared to the detail in the event order form or to the banquet order form. Our testing disclosed 31 exceptions related to discounts or incomplete billing.

Below is a list of some exceptions we noted:

- We noted certain line items on the CHI banquet order forms that were not included in the final invoices. CHI management could not provide support for the discrepancy.

- We observed excessive sale discount to CHI and its affiliates.

    - In 2005, Harbor Steps Conference, an affiliate of CHI, was billed 100 percent at cost.
    - In 2006, CTA was granted a 75 percent discount for two functions. CTA paid $310 on two invoices totaling $1,242.
    - One hundred percent (100%) discount was granted to CHI on a $1,243 invoice.

The observed conditions resulted in a financial loss for the Port, as the revenue was not fully realized.

Recommendation

- Port management should closely monitor sale activities to CHI and its affiliates in order to ensure completeness of revenue and to mitigate loss.

Management Response

- *It is standard within the hospitality industry to spot check facilities to make sure they are performing to an established standard. By using the BHICC facilities for some CHI events, CHI is performing these audits. These audits are done "at cost".*

- *The following seemed to be common "exceptions" noted by Internal Audit:*
  - *Waiver of Room Rental – Room rental is often waived depending on the circumstances of what else is using a facility. For the above CHI audits, room rental would not be charged and the events would not be booked on a day that would displace revenue at retail rates. Internal Audit noted a couple of other events that were over $20,000 that were not charged room rental. Again, depending on other usage of the facility, CHI may make this concession to get the business.*
  - *Varying prices- Highlighted was a difference between champagne prices charged in 2005 and 2007. Prices charged change depending on what product is served.*
  - *CTA discounts are provided for preseason and postseason events for sharing the same space often very close to the same time (i.e. events ending at 12:00AM that require CHI to turn the facility from a banquet facility to a cruise facility by 4:00AM). This coordination has allowed CHI to leverage event sales.*
  - *Harbor Steps Conference Center was a small conference center without kitchen facilities. Selling meals from BHICC to Harbor Steps Conference Center contributed to overhead cost recovery while leveraging marketing opportunities for BHICC through Harbor Steps.*
  - *With BHICC being one of the larger facilities, CHI orientation is held at BHICC and CHI bills out the appropriate parties.*
  - *Item 35 was actually a BHICC event for New Year's Eve, 12/31/07. BHICC benefited most from cash bar receipts.*

So that Port staff can better monitor related party sales activity in the future, the monthly reporting package has been expanded to include formal communications on related party activity including related party use of the BHICC facility and services.

Management Overall Response

Port staff appreciates the considerable efforts provided by Internal Audit in completing an extensive audit of the Bell Harbor International Conference Center Management Services Agreement. As a result of the audit recommendations, certain processes have been or will be put in place to address risk areas that are not otherwise covered within the provisions of the Management Agreement:

- *The monthly reporting package requirements for BHICC have been expanded to include formal communications on related party transactions, legal and regulatory issues and other significant issues.*

- *The monthly owner's meeting has been expanded to include a separate meeting to discuss the financial statements. Formerly the marketing and financial results were both discussed at one meeting with marketing. The separation puts a higher degree of focus on the review of the financial results.*

- *For the 2010 Budget and going forward, Port staff will discuss the methodology and review the cost allocations percentages for key CHI staff assigned to BHICC for reasonableness. In addition, significant changes to the allocation percentages during the year will be required to be reported in the monthly reporting package.*

Though there are areas for improvement as discussed above, Port staff disagrees with the premise that it was/is ineffective in monitoring the BHICC Management Agreement. There is continuous active monitoring of the Management Agreement. However, the Management Agreement never contemplated nor provided for Port staff to be monitoring procedures down to the accounting entry level as appears to be suggested by Internal Audit through their findings and the statement: "The audit disclosed a number discrepancies to include questionable expenses. An effective ongoing monitoring system should have identified and remedied the discrepancies".

The Management Agreement Section G.12 does provide for the audits. It is the Port staff's position that the level of monitoring as suggested by Internal Audit was to be accomplished through the audit process. This function should be performed by the Port of Seattle's Internal Audit Department through a rotating audit schedule. With the recent change in roles for the Internal Audit Department, the Real Estate Division, may need to consider bringing in external independent auditors to perform periodic audits of CHI's records for BHICC.

Overall Auditor's Comment

Internal Audit appreciates the department's receptiveness to the recommendations to strengthen existing controls. Internal Audit strongly believes such an attitude toward the improvement of controls will add value not only to the department but more importantly to the Port. However, Internal Audit disagrees with management's assertion regarding the premise of the report. Internal Audit does acknowledge the presence and performance of certain "continuous active" monitoring controls. It is the overall design and effectiveness of those controls that Internal Audit questions. It is evident that the controls are not working effectively to address meaningful risks associated with this agreement. Because of the nature and structure of this agreement, Internal Audit believes that some detailed monitoring is required in order to provide accountability of public funds. It's the management responsibility to establish the level of monitoring procedures based on meaningful risks associated with this agreement.